Market Perspectives

Sentinel Trust Company, LBA
Investment Committee
Bruce L. Swanson, PhD

JULY 2019

June Re-Cap

U.S. and European central banks promised to take precautionary "insurance" measures despite full-employment conditions in much of the developed world that could cause inflation. Their concern was that trade-war-related uncertainties might favor the deflationary forces of the ever-worsening global manufacturing recession over late-stage economic-expansion pressures, thereby threatening the vibrant services economy. Reflation expectations drove not only outsized equity market gains, but also strength in the global government and credit fixed-income markets. The disproportionate bond market response to the dovish Federal Reserve Board (Fed) guidance contributed to broad-based dollar weakness and commodity market strength. Geopolitical developments like the President Trump/Chinese President Xi trade talks and the Iranian escalations in the Middle East ("accidental" drone downing and uranium enrichment threats) took a back seat.

The 6.5% global equity rally was broad-based and macro-driven, with only 11 of the 94 markets tracked by Bloomberg generating negative returns. U.S., international developed and emerging market shares each posted 6-7% gains, with domestic shares outperforming. At the global level, "high volatility" and "sell side expected return" were the most important return drivers. Momentum and "14-day relative strength" exposures detracted.

The broad U.S. index returned 7.0%, with little headline differentiation between styles and capitalizations. Value modestly outperformed growth shares by 20 basis points (bp), but small-cap growth shares returned 7.7% (130bp ahead of small-cap value peers). The return dispersion was more apparent at the sector level as materials (11%), energy (9%) and technology (9%) paced advancers. Communication services (4%), utilities (3%) and real estate (2%) lagged.

International Markets

International developed-market shares gained 5.7%, with small-cap shares lagging at 4.2%. Growth beat value by 100bp. Markets most leveraged to monetary stimulus, both directly and as part of the potential global reflation, outperformed. Trade-sensitive Sweden and Singapore matched Eurozone shares, which were led by Italy (sensitive to interest rates, trade, European Central Bank policy and recession risks), with 8-10% gains. The U.K. and Japan lagged at 3-4% due to headwinds from Brexit uncertainty and the upcoming October sales tax increase.

"The U.K. and Japan lagged at 3-4% due to headwinds from Brexit uncertainty and the upcoming October sales tax increase."

Emerging market shares followed a similar pattern by gaining 6%. Small cap shares underperformed at 3.9% and growth beat value by 130bp. Declining U.S. short-term interest rates reduced China capital-flight risks and outweighed trade tensions. Hong Kong shares gained 7% and China A-shares recovered from a 2% early-month decline to post a 4% return. The positive spillover boosted other Asian markets such as Thailand, which joined resource-rich Columbia and South

Africa by posting 8-10% gains.

The Argentine market scored a 30% gain in June on positive economic and political news as incumbent Present Macri boosted his re-election odds with the selection of a moderate running mate. Jamaica gained 11% following an upbeat International Monetary Fund (IMF) report that confirmed the country's continued adherence to strong fiscal discipline. The Zambia market plunged 14% following the government's plan to nationalize an important copper mine, giving rise to fears of a broader 1970s-type nationalization program that drove a 30% fall in production. (Zambia produces 3.5% of world's copper.) The Karachi (Pakistan) index also fell 14% as the administration's foreign debt-funded social welfare program reached its logical terminus, with only the IMF potentially available to provide lender-of-last resort emergency funding.

Economic Developments

U.S. economic reports remained positive on a net basis, with supersized retail sales growth outweighing surprisingly weak May employment reports. Even considering the inflation shortfall, there were no domestic developments that would justify an interest rate cut. The big news for the month was a blowout May retail sales report, suggesting that consumption would accelerate from 1.3% in the first quarter to more than 3% in the second. In addition, first-quarter capital spending was revised up from 2.3% to 4.4%, with the software estimate nearly doubling to 17%. Finally, the Institute for Supply Management services report surprised to the upside, with a big jump in the employment component.

In contrast, both the ADP and official payroll reports badly disappointed, with gains of only 27,000 and 75,000, respectively. The weak ADP report was partially a weather-related payback for the strong April report. The best that can be said about the official report is that the 3-month average was still a healthy 150,000 (well above the Fed's usual sub-100,000 threshold for rate cuts). Other reports were mixed:

- manufacturing fell to a 31-month low, but the employment component was surprisingly strong;
- consumer confidence fell more than expected to 2-year lows, but remained not far from 15-year highs;
- residential home starts declined, but mortgage applications surged; and
- while the Fed's primary inflation metric (core Personal Consumption Expenditures) remained below target at 1.6% on a trailing basis after increasing 0.2% in May, an uptick in Producer Price Index services inflation implied broader service-sector inflation increases to come (although unit labor costs were revised to decline even more).

International reports disappointed as Japan's manufacturing Purchasing Managers' Index fell below 50 and leading economic indicators also fell sharply. While European unemployment hit post-recovery lows, the German rate increased for the first time this cycle, reflecting the weak global manufacturing sector which fell into recession territory. After subsequent bad industrial production numbers, the Bundesbank lowered Germany's 2019 growth estimate to 0.5%. European inflation numbers also disappointed with some sub-1% readings, perhaps impacted by the timing of the Easter holiday.

Central Bank Actions and Interest Rates

Rather than any new domestic developments, the Fed's rate-cutting push was more a reaction to 1) the seemingly endless manufacturing slowdown that continues to get worse, 2) disappointing news in Europe and Japan, 3) the European Central Bank's (ECB) willingness to return to quantitative easing and 4) the persistent inflation shortfall.

Following the disappointing economic reports, President Draghi more than made up for his "lapse" by effectively promising renewed quantitative easing measures unless conditions improved. The tone was sufficiently strong to depress bond yields, weaken the Euro and elicit fears of a currency war as President Trump accused Europe of acting unfairly. While the ECB and Fed actions were not formally coordinated, it was not coincidental that the Fed effectively green-lighted investors' aggressive rate-cut hopes. The net result by month-end was that, emboldened by the Fed, the bond market had priced in a guaranteed July rate cut, with the odds of a cumulative 75bp cut by year-end more likely than not.

Benchmark U.S. Treasuries gained 0.9%. Intermediate-term issues outperformed at 1.4% as 10-year yields fell 12bp to 2.01%, while 30-year yields fell only 8bp. Credit market performance varied more directly as a function of duration and non-dollar exposure than the headline rating, with investment grade corporate bonds in the sweet spot. Municipal bonds lagged, quite severely in the longer maturities, as the structural presence of issuer call options served to reduce duration at the worst-possible time as evidenced by the 0.3% return of 20-year municipals versus a 1.3% gain for similar Treasuries. The interest-sensitive Real Estate Investment Trust and master limited partnership sectors' 2% gain somewhat surprisingly lagged not only equity peers, but even the credit markets.

Currencies and Commodities

Whether viewed at the index or individual country levels, the Fed-induced dollar weakness was pervasive in June. The dollar fell 1.7% against developed market currencies and 2.2% against emerging market currencies. The Fed announcement took pressure off of the Chinese yuan, which rose only modestly, but more than the energy-dependent safe-haven Japanese yen.

Resource-based countries (outside of the Middle East), particularly in Latin America, led advancers from a total-return perspective with Argentina returning 10% after reporting a monthly fiscal surplus and Columbia and Chile 5%. South Africa and Russia returned 4%.

Expectations for aggressive central bank interest-rate cuts, the weaker dollar and Iran-related tensions fueled a broad-based 4.4% rally in the Goldman Sachs commodity index, with 75% of the constituents posting monthly gains and only the livestock sub-index in the red. Precious metals gained 7.3%, with palladium up 16% to become the most expensive precious metal for the first time since 2002. (Tougher Chinese emissions standards, hedge fund purchases and hopes/fears for a miners' strike in South Africa added to longstanding supply concerns.) Dollar weakness, geopolitical uncertainty and dovish monetary guidance drove gold's 8% gain to a 6-year high, with silver and platinum adding 5%. Reflation hopes contributed to a 2% gain for industrial metals, led by 6-7% gains for lead and zinc. The energy complex gained 4%, as 8% gains in West Texas Intermediate crude and gasoline offset the 6% decline in natural gas on increased inventories and growing overseas LNG capacity.

Early July and Portfolio Positioning

The first 10 days in July have witnessed modestly positive net economic news as a surprisingly strong June U.S. employment report (224,000 versus 150,000) was mostly offset by a further downturn in the global manufacturing sector. After inputting the new data into their Fed reaction predictions, investors modestly dialed back their interest-rate-cut predictions, but continued to view a cut in July as a near-certainty. Mid-year testimony from Fed Chair Powell only reaffirmed those beliefs despite the 224,000 payroll number. July 11th brought forth a different dynamic in the form of an unexpected increase in core inflation to 2.2% (3-month annualized) and 2.1% on a trailing-year basis. The inflation blip and the Powell guidance had bond investors voting with their feet, with the long bond falling 1.8 points as yields spiked 9bp.

Treasuries were weaker. While 6-month yields were little changed, overall Treasury yields were significantly higher (roughly 15bp for maturities of 3 years and longer). The dollar has bounced off last month's losses with a 1% gain against developed markets, but it fell an additional 0.5% against emerging market currencies. Global equities gained 1%, with U.S. shares gaining 2%.

"Our positioning for some time has been based upon a view that the outlook for the U.S. economy was stronger than commonly believed, but that the equity market was overvalued."

Our positioning for some time has been based upon a view that the outlook for the U.S. economy was stronger than commonly believed, but that the equity market was overvalued. Given that prescient economic call, our process has led us to successfully buy cyclic stocks on weakness owing to recession fears (most particularly December, but also in May), but then sell into subsequent strength.

Chairman Powell's Fed has made a radical departure from conventional practice in seemingly endorsing the bond market's pricing of four rate cuts by next Fall. This comes at a time when unemployment is at record lows, the stock market is at record highs, the economy is continuing to grow at above trend levels, and inflation is not far from target levels. The net result is that U.S. financial conditions are easier than the average over the past five years and in line with September 2014 levels, a time when the unemployment rate was over 6%. Chairman Powell excised any reference to his recent pronouncement that the inflation dip would prove "transitory" and remained conspicuously silent over financial stability risks. Given the latter, it seems only fair to note that current financial conditions are similar to those prevailing in the second half of 2007, another time of unemployment lows and equity highs.

The Fed could point to the trade war uncertainties amidst the continued deterioration in global manufacturing as justification for its outsized "insurance policy." However, its motivation was less data dependent than strategic, both in terms of a persistent shortfall of inflation relative to the its 2% target and the gravitational pull downwards towards rates in other markets (particularly the Eurozone). The Fed views the economy's inability to pierce the 2% inflation target despite an overheated labor market as an existential threat to its ability to sufficiently cut rates in the next recession. The recent uptick in U.S. productivity has been great news for the economy but bad news from a narrow inflation-targeting perspective. The proximal catalyst for the Fed's apparent imminent rate cut was ECB President's Draghi's parting gift in the form of the commitment to restart quantitative easing should growth and inflation not pick up. His desire to "lock-in" his successor to a continued uber-accommodative policy stance proved superfluous when IMF Chief Christine Lagarde, a savvy political insider and noted proponent of negative rates, was the surprise successor over more favored hard-money Northern European candidates.

Growth in 2019 has continued to surpass even my highly optimistic expectations, with the second quarter likely to exceed 1.7%, despite an inevitable give-back from the first quarter with the drag from inventory destocking and net trade. Whatever the negative near-term effects from costs and uncertainties related to the trade war, structural forces in the form of a fully utilized labor market will ultimately cap upside growth potential at well below 2% levels as the cyclic component of employment growth is already behind us. Since the labor market tightness was one of the few pockets of potential late-cycle excess, near-term recession risks remain low, particularly after what appears to be paradigm-shifting Fed rate-cut plans. For now, I am sticking to my call that growth will maintain trend 1.7% levels throughout 2019, although I now see more risks to the downside given the trade-related uncertainties.

With a growth outlook no better than consensus and a continued rally unsupported by fundamentals, my equity market view has become even less constructive as the downside risk is greater than commonly appreciated. Investors are taking too much comfort in seemingly benign price-to-earnings (P/E) ratios, particularly when viewed on a forward basis and/or relative to Treasury yields. The S&P500's 2020 P/E of 16.3 (6.2% "earnings yield") versus a 2% Treasury rate is a typical example. Unfortunately, the reliance on P/E ratios without reference to the stage of the economic cycle and the related level of corporate margins is often misleading.

Not only are valuations unattractive, some of the troubling internal market dynamics are Fed-induced. The ongoing unorthodox policies of developed market central banks have served to distort the price signal for market risk. The reason is that interest-rate repression and the associated reach for yield have encouraged financial "innovation" in the form of "volatility harvesting" strategies and "auto-callable" structured products. While the strategies are different, they are based upon empirical evidence that insurance, in the form of puts on the market, is systemically overpriced, at least in expected value terms. Both strategies have the effect of suppressing option and market volatility in most environments, but only until the point when something breaks at which time the unwinding of these strategies feeds further volatility and downside movement.

Long-term earnings growth forecasts of 10% seem overly optimistic, partly because revenue growth will disappoint if growth is capped at 1.5% and inflation stays low. More importantly, margins are assumed to improve over a period where they are more likely to fall from their highs, due to the tight labor market. All of this assumes away any recession risk, an event that could easily take earnings down 20% in a year. From a nearer-term perspective, 2019 S&P earnings estimates were highly back-loaded even before the trade-war escalation; there is recent evidence of slippage as fourth-quarter estimates have fallen 4% over the past month. Given current valuation levels, it remains to be seen whether investors will look across any "valley" to the horizon of a reflating global economy should growth or earnings disappoint in the interim.

With a focus on long-term expected returns, our tactical positioning process gives primacy to current valuations, but views them within the context of a macro-economic framework, which serves to either reinforce or dilute our valuation-based analysis. For many months, despite evidence that the market was overvalued, our macro outlook was much more optimistic than consensus, giving us the confidence to purchase the more cyclic parts of the market on recession fears or other periods of dislocation.

Unfortunately, at this time, while recession risks are low, the macro context provides little encouragement to accept the risk/reward on offer in the market. Positioning changes are likely to take several forms, particularly as I confirm that the Fed has really made the radical shift that it appears. Having already reduced U.S. equity exposure, we will be more aggressive sellers into strength, while being more patient in rebuilding exposure on any dips.

Together, families prosper℠